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SUBJECT: Citigroup Turning Around Troubled Guangdong Development Bank

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¶1. (SBU) Summary: Citigroup has made impressive progress in turning around Guangdong Development Bank (GDB) in the year since it invested in the bank and installed new management. GDB predicts a profit of RMB 1.67 billion (about US\$230 million) for 2007 after sizeable losses a year earlier. However, senior management described the challenges of changing a culture of lending based on relationships, working with the bank's Communist Party organization, and cooperating with investment consortium partners. Citigroup hopes eventually to raise its stake in GDB to make it a platform for the group's expansion in China, but it also has other goals in mind for its investment in GDB. End summary.

Reforming a "Profoundly Troubled" Bank

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¶2. (SBU) GDB President Michael Zink described impressive progress in turning around what had been a "profoundly troubled" bank when he took the helm one year ago. Zink, a Citigroup employee who was seconded to GDB after Citigroup led a consortium to purchase an 85-percent stake in the bank, has two years left on his three-year contract with GDB. He explained to us on November 23 that when the Chinese government founded GDB, the "Development Bank" part of its title wasn't just a name. GDB was created to make loans that would encourage development in Guangdong Province, not necessarily loans that would earn money for the bank. As a result, the most challenging job for the new management team, led by a small group of Citigroup employees, has been changing the culture of awarding loans based on connections, or "guanxi," and instead creating a more rigorous risk assessment and management system.

¶3. (SBU) Zink proudly pointed to several measures of improved performance at GDB in the last year; most notably, the bank will show a profit of about RMB 1.67 billion (US\$230 million) in 2007 after a loss of more than RMB 600 million the previous year. In addition, the bank aims to reduce its non-performing loan ratio below 3.3 percent by the end of the year, down from 6.68 percent when Citigroup bought its stake. Zink also said the bank had significantly raised its capital adequacy ratio.

With Friends Like These - The Chairman and the Party

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¶4. (SBU) Working out a modus vivendi with GDB's Communist Party organization has been a major challenge for the new management team, according to Zink. To underscore the power of the Party organization within the bank, Zink speculated that if the Chairman of the Board of Directors, who also serves as the bank's Party Secretary, was forced to choose between those two titles, he would

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choose to be Party Secretary. Zink complained of the Party organization's lack of transparency. In the past, the senior bank management and Party leadership were identical. Now, a new group of top managers, including Zink, is excluded from Party deliberations. He commented that although the management team operated in complete transparency, the flow of communication between management and the Party went in just one direction.

¶5. (SBU) Reaching an understanding on how to handle personnel decisions was the biggest obstacle in Party-management relations. Zink surmised that the ability to name appointments was probably the Party's most jealously guarded power within the bank. However, management would be left with little real authority if it had no role in personnel decisions. He explained that after a lot of back-and-forth on the issue, the two sides had agreed that the Party would nominate a single candidate for open positions and the senior management team would have the authority to reject candidates it deemed unsuitable. There had been some positions that had taken more than one round of nominations to fill, but Zink believes that this arrangement is working fairly well.

With Friends Like These - Partners and Competitors

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¶6. (SBU) In addition to working with the Party structure, the team from Citigroup has faced challenges in working with its investment consortium partners. Because it is restricted as a foreign investor, Citigroup owns only 20 percent of GDB. IBM, the other foreign investor, owns just under 5 percent. The three Chinese

partners, China Life, Citic Trust and State Grid Corporation, each own about 20 percent. Zink described both IBM and State Grid, an electric power company, as financial investors with little interest in playing a management role. He said Citic Trust, as a financial services firm, had the potential to become a strategic investor but for now had kept a low profile.

¶7. (SBU) China Life, on the other hand, has behaved more like a strategic investor and potential competitor with Citigroup for control of GDB, according to Zink. He believes that since China Life's main competitor, Ping An Insurance, bought a controlling stake in Shenzhen Commercial Bank, China Life has been eager to enter the banking sector and sees GDB as an important platform. He commented that some disagreements attributed to "cultural differences" among the consortium partners were more about controlling the management of GDB. However, Zink acknowledged that the decision to market China Life insurance products through GDB branches and a GDB-China Life co-branded credit card had been successful.

Playing Nice with the Regulators

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¶8. (SBU) Zink said that GDB's new management team had been proactive in working closely with the China Banking Regulatory Commission (CBRC) about reform and development plans for the bank. GDB has notified CBRC well in advance of any changes at the bank. After pushing forward rapidly with reforms in the early stages of the takeover, Zink and his managers decided to slow down the pace of change to give CBRC more time to absorb their plans. Zink pointed out that because of the foreign stake in GDB, CBRC monitors it more closely than most Chinese banks.

Planning for the Future

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¶9. (SBU) Looking forward, Zink told us that Citigroup hopes it might eventually be able to raise its stake in GDB and use it as a platform to extend the group's reach into China's second- and third-tier cities. However, he explained that even if Citigroup is

not permitted to increase its stake, the investment could still be a success for the group. To begin with, he believes that changes at GDB have already substantially raised the value of Citigroup's investment in the bank. In addition, Zink said the venture was helping Citigroup achieve more abstract goals: learning more about China's banking market and demonstrating Citigroup's commitment to strengthening China's financial system.

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